Determining the Value of a Business

August 15, 2017 @ 11 a.m. Eastern

For technical assistance, contact the AT&T Helpdesk at 888-796-6118 - Thank you!

U.S. Small Business Administration

We would like to thank Neal for his time and providing information regarding his experience on SBA lending programs from his perspective.

All opinions, conclusions, and/or recommendations expressed herein are those of the presenter and do not necessarily reflect the views of the SBA.

SBA

U.S. Small Business Administration

Advanced Business Acquisition / Appraisal Topics

Presented by:

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Neal Patel, CBA, CVA

- Neal Patel, CBA, CVA is the Principal of Reliant Business Valuation, a business valuation and equipment appraisal firm specialized in SBA related valuations nationwide.

- Our firm currently works with over 150 SBA lenders around the nation.

- Certified Business Appraiser through the Institute of Business Appraisers (IBA) (Chair of the Board of Governors)

- Certified Valuation Analyst through the National Association of Certified Valuators and Analysts (NACVA).

SBA/Structure Related

- Intangible Assets
- Partner Buyouts
- Stock vs. Asset Sales
- Other SBA Rules

Valuation Related

- Cash Flow Analysis: Liquor Store
- Valuation Methods
- Valuation Rules of Thumb
- Price / Revenues

When is a Third Party Appraisal Required?

(Non Special Purpose Property)

If the amount being financed (*<u>including any 7(a), 504, seller or other financing</u>*) minus the appraised value of real estate and/or equipment is greater than $250,000, ***or..***

Note: no mention of goodwill!

If there is a close relationship between the buyer and seller (for example, transactions between family members or business partners), ***or..***

Note: employee / employer also included!

If the lender's internal policies and procedures require an independent business appraisal from a qualified source

Note: every change of ownership loan requires a business appraisal !

Intangible Assets: SOP Definition

SOP 50 10 5(I) pg. 114

The value of the intangible assets is determined by...the value of the business as identified in the business appraisal minus the sum of the working capital assets and the fixed assets being purchased.

In other words:

intangible assets =

business value – (working capital* + fixed assets)

*Working Capital = Current Assets – Current Liabilities

Intangible Assets: SOP Definition

Final Value	$700,000
Cash or Cash Equivalent	$0
Accounts Receivable	$0
Inventory	$50,000
Other Current Assets	$0
Fixed Assets (net book value)	$100,000
Other Assets	$0
Total Tangible Assets Included in Value	$150,000
Current Liabilities	$0
Long Term Liabilities	$0
Total Liabilities Included in Value	$0
Assets less Liabilities (rounded)	$150,000
Final Value minus (Assets less Liabilities)	
Total Intangible Assets Included in Value	$550,000

Intangible Assets: SOP Definition

Final Value	$700,000
Cash or Cash Equivalent	$0
Accounts Receivable	$0
Inventory	$50,000
Other Current Assets	$0
Fixed Assets (**appraised** value)	$250,000
Other Assets	$0
Total Tangible Assets Included in Value	$300,000
Current Liabilities	$0
Long Term Liabilities	$0
Total Liabilities Included in Value	$0
Assets less Liabilities (rounded)	$300,000
Final Value minus (Assets less Liabilities)	
Total Intangible Assets Included in Value	$400,000

Intangible Assets: SOP Definition

Final Value	$600,000
Cash or Cash Equivalent	$0
Accounts Receivable	$0
Inventory	$50,000
Other Current Assets	$0
Fixed Assets (**appraised** value)	$250,000
Other Assets	$0
Total Tangible Assets Included in Value	$300,000
Current Liabilities	$100,000
Long Term Liabilities	$0
Total Liabilities Included in Value	$100,000
Assets less Liabilities (rounded)	$200,000
Final Value minus (Assets less Liabilities)	
Total Intangible Assets Included in Value	$400,000

Initial Use of Proceeds Table

Final Value	$700,000
Cash or Cash Equivalent	$0
Accounts Receivable	$0
Inventory	$50,000
Other Current Assets	$0
Fixed Assets (net book value)	$100,000
Other Assets	$0
Total Tangible Assets Included in Value	$150,000
Current Liabilities	$0
Long Term Liabilities	$0
Total Liabilities Included in Value	$0
Assets less Liabilities (rounded)	$150,000
Final Value minus (Assets less Liabilities)	
Total Intangible Assets Included in Value	$550,000

Even before the appraisal is ordered, you can setup the use of proceeds…

..using the net book value of tangible assets, to give you the most accurate intangible asset value.

Table 2

Purchase Price	$700,000
- Tangible Assets (book value as per B/S)	$150,000
= Intangible Assets (estimated)	$550,000

Assume that Final Value is equal to Purchase Price – adjust post appraisal if required.

Important Reminder: Transaction Type

SOP 50 10 5(I) States: *"The scope of work should identify whether the transaction is an asset purchase or stock purchase and be specific enough for the individual performing the business appraisal to know what is included in the sale (including any assumed debt)."*

- All assets and liabilities that are included in the final transaction must be included in the business appraisal. This is similar to the basic concept of "comparing apples to apples".

The value of a business includes:

Cash Flow x Multiple = Asset Value

$215,000 x 3.0 = $650,000

- The value above includes:
  - all operating assets (FF&E)
  - all intangible assets (goodwill)

Important Reminder: Transaction Type Example 1

Enterprise value derived from previous slide…	
Enterprise Value	$650,000
+ Inventory	$50,000
= EV + Inventory	$700,000
If transaction includes $50M A/R	
+ Accounts Receivable	$50,000
	$750,000
If transaction also includes $50M A/P	
- Accounts Payable	-$50,000
	$700,000

Important Reminder: Transaction Type Example 2

Enterprise Value	$650,000
If transaction includes $200M in Target NWC	
+ Current Assets	$250,000
- Current Liabilities	-$50,000
= Net Working Capital	$200,000
Value includes Net Working Capital	
+ Value incl. NWC	$850,000
At closing, NWC balance should be confirmed.	

Sample Company ABC

Adjusted Book Value

Cash Basis	Internal 6/30/2017	Operating Yes/No	Adjusted Book Value	Included in Value	Included in Final Adj. Book Value
ASSETS					
Current Assets					
Cash and Equivalent	50,000	Yes	50,000	Yes	50,000
Accounts Receivable	200,000	Yes	200,000	Yes	200,000
Inventory	-		-		-
Other Current Assets	20,000	Yes	20,000	No	-
Total Current Assets	270,000		270,000		250,000
Fixed Assets*					
Office Furniture and Equipment	100,000	Yes	100,000	Yes	100,000
Vehicles	50,000	Yes	50,000	Yes	50,000
Leasehold Improvements	50,000	Yes	50,000	Yes	50,000
Other	-		-		-
Less: Accum. Depreciation	(150,000)	Yes	(150,000)	Yes	(150,000)
Total Fixed Assets	50,000		50,000		50,000
Other Assets**					
Amortizable Assets	450,000	No	-		-
Less: Accum. Amortization	(250,000)	No	-		-
Other Assets	-		-		-
Deposits	-		-		-
Total Other Assets	200,000		-		-
Total Assets	520,000		320,000		300,000
LIABILITIES AND EQUITY					
Current Liabilities					
Trade Accounts Payables	50,000	Yes	50,000	Yes	50,000
Service Deposits	-		-		-
Sales Tax Payable	-		-		-
Credit Cards	-		-		-
Total Current Liabilities	50,000		50,000		50,000
Long Term Liabilities					
Long Term Loan	-		-		-
Other Liabilities	-		-		-
Other Liabilities	-		-		-
Total Long-term Debt	-		-		-
Total Liabilities	50,000		50,000		50,000
Equity					
Capital Stock	50,000				-
Retained Earnings	100,000				-
Additional Paid in Capital	670,000				-
Total Equity	820,000	Adjusted	270,000	Adjusted	250,000
Total Liabilities and Equity	870,000		320,000		

Partnership Buyout

Can the owner's existing equity in the business be used to satisfy the 25% "equity requirement"?

- Example: 25% partner is buying out a 75% partner's ownership interest, resulting in 100% ownership vesting in the purchaser.
- The business appraisal reflects a pre-sale stock value equaling $1,000,000
  - value includes all assets and liabilities (pre-sale)
  - value of interest being purchased is assumed to include $500,000 intangible assets

Partnership Buyout

Table 1: 75% Partner Buyout (non-PLP)

[Appraised] Pre-Sale Stock (Equity) Value	$1,000,000
Loan for Partner Buyout	750,000
Loan for Working Capital	50,000
Loan for Closing Costs	50,000
Total SBA Loan Amount:	$850,000
[Appraised] Pre-Sale Stock (Equity) Value	$1,000,000
Add: Working Capital	50,000
Gross Pro Forma Stock (Equity) Value	1,050,000
Less: Total SBA Loan	850,000
Net Pro Forma Stock (Equity) Value	$200,000

The purchasing partner does not retain 25% equity in the business.

Pro Forma Stock (Equity) Percentage $= \dfrac{\$200{,}000}{1{,}050{,}000} =$ 19%

Partnership Buyout

$$\text{Pro Forma Stock (Equity) Percentage} = \frac{\$200{,}000}{1{,}050{,}000} = 19\%$$

Multiply Pro Forma Stock Value by 25% to calculate the difference that buyer is required to inject…

Gross Pro Forma Stock (Equity) Value	1,050,000
Times 25%	25%
Buyer's Required Pro-Forma Equity	$262,500

Buyer needs to inject $62,500 to have 25% equity.

Partnership Buyout

Table 2: 75% Partner Buyout (PLP)

[Appraised] Pre-Sale Stock Value	$1,000,000
Loan for Partner Buyout **(reduced)**	$687,500
Loan for Working Capital	$50,000
Loan for Closing Costs	$50,000
Total SBA Loan Amount:	$787,500
[Appraised] Pre-Sale Stock Value	$1,000,000
Add: Working Capital	$50,000
Pro forma Stock Value	$1,050,000
Less: Total SBA Loan	($787,500)
Pro forma Equity	$262,500

Pro forma Equity Percentage $= \frac{\$262{,}500}{\$1{,}050{,}000} =$ 25.0%

Loan for Partner Buyout	$687,500
Buyer's Equity Injection	$62,500
Total Partner Buyout	$750,000

As reflected in Table 2, the borrower must inject additional equity of $62,500, thereby reducing the Partner Buyout portion of the loan, to meet the 25% equity requirement.

Equipment Appraisals

- When ordering an equipment appraisal, <u>always request both standards of value</u>

- Fair Market Value (FMV)
  - No time restriction to sell assets
  - FMV of equipment can be used in Business Appraisal in lieu of Net Book Value

- Orderly Liquidation Value (OLV)
  - Approx. 90-120 Days and typically 65% of Fair Market Value
  - **SBA SOP Collateral Requirements** (SOP 50 10 5(I) pg. 155)

"Used or existing machinery and equipment may be valued at 50% of Net Book Value or 80% with an Orderly Liquidation Appraisal minus any prior liens for the calculation of "fully-secured."

Other SBA Rules

- Earn-outs are NOT permitted
  - Not stated in SOP, but confirmed by SBA
- Seller note CAN be bifurcated
  - Assume PLP deal, intangible assets > $500M
  - Buyer injection: 10%, Seller holds 25%
  - Seller note #1: 15% (fully standby (no P&I) for 2 years)
  - Seller note #2: 10% (P&I can start on day 1)

[Stress-test your standby seller note in year 3, check DSCR!]

- Seller's Involvement Post-Sale

2. The seller may not remain as an officer, director, stockholder or key employee of the business. (13 CFR §120.130) (If a short transitional period is needed, the small business may contract with the seller as a consultant for a period not to exceed 12 months including any extensions.)

- SBA: "It's possible for a seller to remain on as an employee, so long as the seller is not a "key" employee.
- Most SBA attorneys say: "don't take a chance, cutoff at 12 months"

The Valuation Process

- Cash Flow Analysis: Liquor Store
- Valuation Methods
- Reasonable Valuation Multiples
- Pitfalls of Price / Revenue Multiple

Liquor Store – LLC

Form **1065**

Department of the Treasury
Internal Revenue Service

U.S. Return of Partnership Income

For calendar year 2011, or tax year beginning ____________, 2011, ending ____________, 20 ____.

► See separate instructions.

OMB No. 1545-0099

2011

Income	1a Merchant card and third-party payments (including amounts reported on Form(s) 1099-K). For 2011, enter -0-	1a	0		
	b Gross receipts or sales not reported on line 1a (see instructions)	1b	2,211,481		
	c Total. Add lines 1a and 1b	1c	2,211,481		
	d Returns and allowances plus any other adjustments to line 1a (see instructions)	1d			
	e Subtract line 1d from line 1c	1e	2,211,481		
	2 Cost of goods sold (attach Form 1125-A)	2	1,732,334		
	3 Gross profit. Subtract line 2 from line 1e			3	479,147
	4 Ordinary income (loss) from other partnerships, estates, and trusts (attach statement)			4	
	5 Net farm profit (loss) (attach Schedule F (Form 1040))			5	
	6 Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797)			6	
	7 Other income (loss) (attach statement) STM. 02			7	82,156
	8 **Total income (loss).** Combine lines 3 through 7			8	561,303
Deductions (see the instructions for limitations)	9 Salaries and wages (other than to partners) (less employment credits)			9	98,114
	10 Guaranteed payments to partners			10	
	11 Repairs and maintenance			11	12,432
	12 Bad debts			12	
	13 Rent			13	144,000
	14 Taxes and licenses See ATT PTL			14	15,166
	15 Interest			15	30,105
	16a Depreciation (if required, attach Form 4562)	16a	28,644		
	b Less depreciation reported on Form 1125-A and elsewhere on return	16b		16c	28,644
	17 Depletion **(Do not deduct oil and gas depletion.)**			17	
	18 Retirement plans, etc.			18	
	19 Employee benefit programs			19	
	20 Other deductions (attach statement) STM. 04			20	142,549
	21 **Total deductions.** Add the amounts shown in the far right column for lines 9 through 20			21	471,010
	22 **Ordinary business income (loss).** Subtract line 21 from line 8			22	90,293

Liquor Store – LLC

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Liquor Store – Cash Flow

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Department of the Treasury
Internal Revenue Service

U.S. Return of Partnership Income

For calendar year 2011, or tax year beginning ____________, 2011, ending ____________, 20 ____.

► See separate instructions.

OMB No. 1545-0099

2011

Deductions (see the instructions for limitations)	9	Salaries and wages (other than to partners) (less employment credits)			9	98,114
	10	Guaranteed payments to partners			10	
	11	Repairs and maintenance			11	12,432
	12	Bad debts			12	
	13	Rent			13	144,000
	14	Taxes and licenses See.ATT_PTL			14	15,166
	15	Interest			15	30,105
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	17	**Depletion (Do not deduct oil and gas depletion.)**			17	
	18	Retirement plans, etc.			18	
	19	Employee benefit programs			19	
	20	Other deductions (attach statement) STM. 04			20	142,549
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Step 1: Calculate EBITDA

Liquor Store – Cash Flow

Form **1065**

Department of the Treasury
Internal Revenue Service

U.S. Return of Partnership Income
For calendar year 2011, or tax year beginning ____________, 2011,
ending ____________, 20 _____.
► See separate instructions.

OMB No. 1545-0099

2011

Deductions (see the instructions for limitations)	9	Salaries and wages (other than to partners) (less employment credits)			9	98,114
	10	Guaranteed payments to partners			10	
	11	Repairs and maintenance			11	12,432
	12	Bad debts			12	
	13	Rent			13	144,000
	14	Taxes and licenses See ATT PTL			14	15,166
	15	Interest			15	30,105
	16 a	Depreciation (if required, attach Form 4562)	16a	28,644		
	b	Less depreciation reported on Form 1125-A and elsewhere on return	16b		16c	28,644
	17	**Depletion (Do not deduct oil and gas depletion.)**			17	
	18	Retirement plans, etc.			18	
	19	Employee benefit programs			19	**Amortization** **$40,000**
	20	Other deductions (attach statement) STM. 04			20	142,549
	21	**Total deductions.** Add the amounts shown in the far right column for lines 9 through 20			21	471,010
	22	**Ordinary business income (loss).** Subtract line 21 from line 8			22	90,293

Step 1: Calculate EBITDA

Liquor Store – Cash Flow

Form **1065**

Department of the Treasury
Internal Revenue Service

U.S. Return of Partnership Income

For calendar year 2011, or tax year beginning ____________, 2011, ending ____________, 20 _____.

► See separate instructions.

OMB No. 1545-0099

2011

Deductions (see the instructions for limitations)	9	Salaries and wages (other than to partners) (less employment credits)		9	98,114
	10	Guaranteed payments to partners		10	
	11	Repairs and maintenance		11	12,432
	12	Bad debts		12	
	13	Rent		13	144,000
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	17	Depletion (Do not deduct oil and gas depletion.)		17	
	18	Retirement plans, etc.		18	
	19	Employee benefit programs		19	Amortization $40,000
	20	Other deductions (attach statement) STM. 04		20	142,549
	21	**Total deductions.** Add the amounts shown in the far right column for lines 9 through 20		21	471,010
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EBITDA Calculation	
Net income (loss) from financials	$ 90,923
Add: Interest	$ 30,105
Add: Taxes	$ -
Add: Depreciation	$ 28,644
Add: Amortization	$ 40,000
EBITDA (unadjusted)	$ 189,672

Liquor Store – Cash Flow

Form **1065** — Department of the Treasury, Internal Revenue Service

U.S. Return of Partnership Income
For calendar year 2011, or tax year beginning ____________, 2011, ending ____________, 20 ____.
► See separate instructions.

OMB No. 1545-0099 — **2011**

Deductions	9	Salaries and wages (other than to partners) (less employment credits)			9	98,114	
	10	Guaranteed payments to partners			10	Officer's Comp	$15,000
	11	Repairs and maintenance			11	12,432	
	12	Bad debts			12		
	13	Rent			13	144,000	
	14	Taxes and licenses . . . See.ATT_PTL			14	15,166	
	15	Interest			15	30,105	
	16a	Depreciation (if required, attach Form 4562)	16a	28,644			
	b	Less depreciation reported on Form 1125-A and elsewhere on return	16b		16c	28,644	
	17	Depletion (Do not deduct oil and gas depletion.)			17		
	18	Retirement plans, etc.			18		
(see the instructions for limitations)	19	Employee benefit programs			19	Owner's Heath	$5,000
	20	Other deductions (attach statement) . . . STM. 04			20	142,549	
	21	**Total deductions.** Add the amounts shown in the far right column for lines 9 through 20			21	471,010	
	22	**Ordinary business income (loss).** Subtract line 21 from line 8			22	90,293	

Step 2: Calculate Normalized Seller's Discretionary Earnings

	EBITDA
+	Owner's Compensation
+	Normalizing Adjustments*
=	Normalized SDE
	**Normalizing Adjustments*
	Non-Recurring Expenses
	Non-Business Expenses
	Owner's Perks
	Rent Adjustment

Typical Add-backs

Owner(s) compensation (over/under compensated)

Manager's Salary (if absentee owned) or Family Salaries (supported by W2's)

Related payroll taxes, benefits, profit sharing

Other Discretionary expenses:

- Spouse's Compensation (if not involved in business)
- Personal auto

Nonrecurring items or events:

- Non recurring legal fees
- Non recurring consulting fees paid to previous owner

Unrelated income / pass through income

Transactions with affiliate(s) (i.e. arm's-length)

Add-backs Not Generally Accepted

- Advertising / Marketing (difficult to know how much revenue was generated)
- Full Rent – If real estate is owned by the business owner, the rent must be normalized to market rates
- Adjusting expenses such as Cost of Goods Sold or Salaries to Industry (RMA) Averages
- Synergistic Add-backs – certain expenses that may change when a specific buyer takes over
- Travel Expenses and Meals/Entertainment Expenses (in most cases)

Liquor Store – Cash Flow

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Department of the Treasury
Internal Revenue Service

U.S. Return of Partnership Income
For calendar year 2011, or tax year beginning ____________, 2011,
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OMB No. 1545-0099
2011

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	22	**Ordinary business income (loss).** Subtract line 21 from line 8			22	90,293

Appraiser's Cash Flow for Liquor Store	
EBITDA	$ 189,672
Add: Owner's Compensation	$ 15,000
Add: Non-Business / Non-Recurring / Owner's "Perks"	$ 5,000
Add: Rent Paid to Affiliate Holding Company (EPC/OC)	$ 144,000
Less: Fair Market Rent	$ (100,000)
Seller's Discretionary Earnings (SDE)	$ 253,672

Sq. Feet	Gross Rent PSF
5,000	$ 20.00

Liquor Store – Cash Flow

Form **1065** Department of the Treasury Internal Revenue Service

U.S. Return of Partnership Income
For calendar year 2011, or tax year beginning ____________, 2011, ending ____________, 20 ____.
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OMB No. 1545-0099

2011

Appraiser's Cash Flow(s)

Appraiser's Cash Flow for Liquor Store	
EBITDA	$ 189,672
Add: Owner's Compensation	$ 15,000
Add: Non-Business / Non-Recurring / Owner's "Perks"	$ 5,000
Add: Rent Paid to Affiliate Holding Company (EPC/OC)	$ 144,000
Less: Fair Market Rent	$ (100,000)
Seller's Discretionary Earnings (SDE)	$ 253,672
Less: Market Replacement Salary for Owner	$ (35,000)
Adjusted EBITDA	$ 218,672

- Adjustment for market comp/rent
- Adjustment for fair market comp

vs. Underwriter's Cash Flow

Cash Flow for Lenders (Underwriters)	
EBITDA	$ 189,672
Add: Owner's Compensation	$ 15,000
Deduct: Buyer's Required Draw	$ (65,000)
Add: Rent Paid to Affiliate Holding Company (EPC/OC)	$ 144,000
Cash Flow Available to Service Debt	$ 283,672

- Adjustment for buyer's draw
- No adjustment for market rent

How is a Business Valued?

Asset approach	• Adjusted Book Value Method
Market approach	• (Similar) Transaction Method
Income approach	• Single Period Capitalization Method • Multi Period Discounted Cash Flow Method

*<u>*Each*</u> approach should be considered in <u>*every*</u> valuation engagement

How are Values Reconciled?

RECONCILIATION						
100% Control Interest in the Company						
Valuation Method:	**Indicated Value**	**Discount/ Premium Rate**	**Confidence Level**	**Weighted Estimate**		
Asset Approach						
Adjusted Book Value Method	700,000					
(No Discounts or Premiums)	-	0%				
Adjusted Value	700,000		0%	-		
Market Approach					Coefficient of Variance	# of x'actions
Direct Market Data Method						
Pratt's Stats Data:						
Price / Sales	2,100,000		0.0%	-	0.80	56
Price / EBITDA	1,450,000		25.0%	362,500	0.35	44
Price / Seller's Discretionary Earnings	1,345,000		25.0%	336,250	0.42	39
BIZCOMPS Data:						
Price / Sales	800,000		0.0%	-	0.75	51
Price / Seller's Discretionary Earnings	1,250,000		25.0%	312,500	0.45	51
(No Discounts or Premiums)						
Income Approach						
Capitalization Method - Control Adjusted	1,545,000					
Less: Illiquidity Discount	(161,477)	10.5%				
Adjusted Value	1,383,523		25%	345,881		
Value - 100% Interest in Company			100%	1,357,131		
Times Interest to be Valued				x 100%		
Value Conclusion - 100% Interest in Company				1,357,131		
Value Conclusion - 100% Interest in Company (Rounded)				**$ 1,360,000**		

Using the Market Approach

- Price / **Sales** multiple
  - Apply a multiple to the sales

Sales	$ 2,000,000
Price / Sales Multiple	0.45
Value	$ 900,000

- The Price / Sales approach does not take into consideration many variable expenses that can impact the cash flow (rent, COGS, salaries, etc.), so this multiple is relied upon infrequently.

Using the Market Approach

- Market Approach is the most frequently used appraisal method for small businesses (sales less than \$2 - \$3 million)

  - Price / **<u>Earnings</u>** multiple
    - Apply a multiple to the earnings

Earnings (SDE)	$ 250,000
Price / Earnings Multiple	4
Value	$1,000,000

Factors that Influence the Multiple

- Owner’s involvement
- Financial Strength
- Transferability of Revenues
- Size of Potential Buyer Pool
- Customer Concentration
- Size of Company / Revenues
- Growth Prospects

- Marketability
- Brand recognition
- Industry and company risk
- Management depth
- Employee retention
- Ease of operations
- Quality of clients
- Product mix

Which Multiple is Reasonable?

What is the relationship between the Price / Earnings multiple and the Rate of Return (or Return on Investment / ROI)?

- **Price / Earnings multiple of 2.0**
  2 x Earnings = 2 year payback period = 1/2 or 50% Return on Investment
- **Price / Earnings multiple of 3.0**
  3 x Earnings = 3 year payback period = 1/3 or 33% Return on Investment
- **Price / Earnings multiple of 4.0**
  4 x Earnings = 4 year payback period = 1/4 or 25% Return on Investment
- **Price / Earnings multiple of 5.0**
  5 x Earnings = 5 year payback period = 1/5 or 20% Return on Investment

Relationship between earnings multiple and capitalization rate…

Normalized SDE (rounded)		250,000		
Chosen Price / Earnings Multiple	x	**2.0**		2 year return
Estimated Value (rule of thumb)		500,000		50% Cap Rate
Normalized SDE (rounded)		250,000		
Chosen Price / Earnings Multiple	x	**3.0**		3 year return
Estimated Value (rule of thumb)		750,000		33% Cap Rate
Normalized SDE (rounded)		250,000		
Chosen Price / Earnings Multiple	x	**4.0**		4 year return
Estimated Value (rule of thumb)		1,000,000		25% Cap Rate

Relationship between earnings multiple and capitalization rate…

Normalized SDE (rounded)		250,000	
Chosen Price / Earnings Multiple	x	**2.0**	2 year return
Estimated Value (rule of thumb)		500,000	50% Cap Rate
Normalized SDE (rounded)		250,000	
Chosen Price / Earnings Multiple	x	**3.0**	3 year return
Estimated Value (rule of thumb)		750,000	33% Cap Rate
Normalized SDE (rounded)		250,000	
Chosen Price / Earnings Multiple	x	**4.0**	4 year return
Estimated Value (rule of thumb)		1,000,000	25% Cap Rate

Typical Multiples for Other Industries

- **Dentist Practice - 2.0x SDE multiple**
  - high chance of attrition if dentist sells
  - small buyer pool (for the business)
  - no brand recognition
  - no depth in management structure

- **Franchised Restaurant - 3.0 – 4.0 SDE multiple**
  - little attrition upon sale
  - large buyer pool (for the business)
  - training manuals / franchise support
  - ease of operations / ability to run absentee

Typical Multiples for Other Industries

- **Insurance Agency - 3.0 – 5.0 SDE multiple**
  - recurring revenues
  - new clients must exceed annual attrition (simple enough!)
  - large buyer pool (including other insurance agencies)
  - no customer concentration

- **Home Health Care - 3.0 – 4.0 SDE multiple**
  - reliant on Medicaid vs. self-pay? Medicaid is risky…
  - large buyer pool
  - no customer concentration
  - possible large depth of management structure

Pitfalls of Price/Revenue Multiples

Dental Practice - Scenario 1		
Revenue	**$ 1,000,000**	**100.0%**
Operating Expenses:		
Owner's Compensation (inc. tax)	150,000	15.0%
Staff Compensation (inc. tax)	290,000	29.0%
Lab Fees	70,000	7.0%
Rent	60,000	6.0%
Clinical Supplies	60,000	6.0%
Other Misc. Expenses	170,000	17.0%
Total Operating Expenses	**800,000**	**80.0%**
Net Income (EBITDA)	**$ 200,000**	**20.0%**
Add: Owner's Compensation	150,000	
Seller's Discretionary Earnings (SDE)	**$ 350,000**	**35.0%**

		Multiple	Value
Value based on SDE	$ 350,000	2.0	$ 700,000
Value based on Revenue	$ 1,000,000	0.7	$ 700,000

Pitfalls of Price/Revenue Multiples

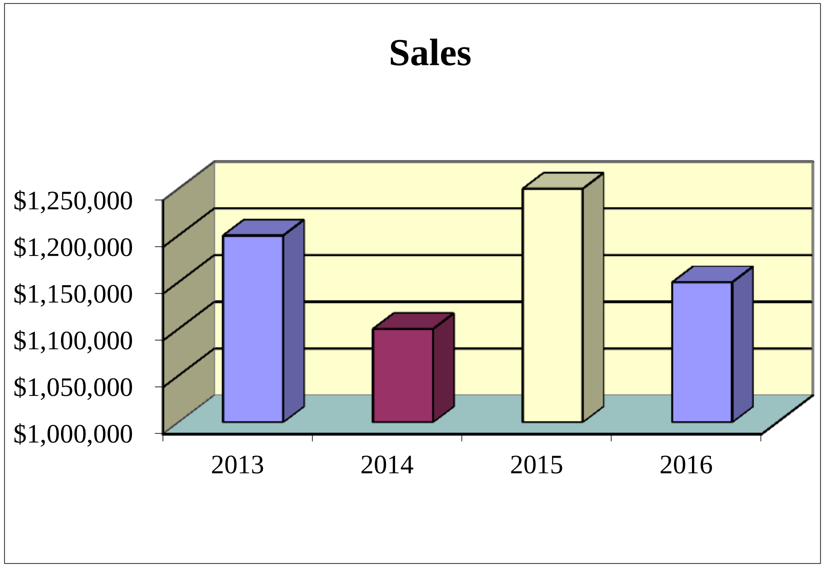
Dental Practice - Scenario 2		
Revenue	**$ 1,000,000**	**100.0%**
Operating Expenses:		
Owner's Compensation (inc. tax)	150,000	15.0%
Staff Compensation (inc. tax)	350,000	35.0%
Lab Fees	70,000	7.0%
Rent	60,000	6.0%
Clinical Supplies	100,000	10.0%
Other Misc. Expenses	170,000	17.0%
Total Operating Expenses	**900,000**	**90.0%**
Net Income (EBITDA)	**$ 100,000**	**10.0%**
Add: Owner's Compensation	150,000	
Seller's Discretionary Earnings (SDE)	**$ 250,000**	**25.0%**

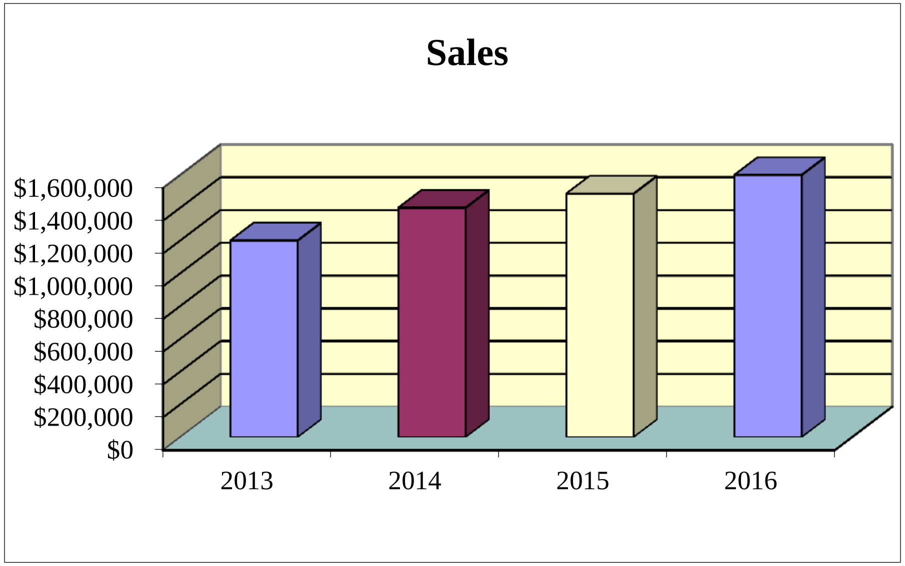
		Multiple	Value
Value based on SDE	$ 250,000	2.0	$ 500,000
Value based on Revenue	$ 1,000,000	0.7	$ 700,000

Frequently Asked:

- **Question** – What year do you place most weight on?

- **Answer** – It depends on growth, volatility, anomalies, etc.





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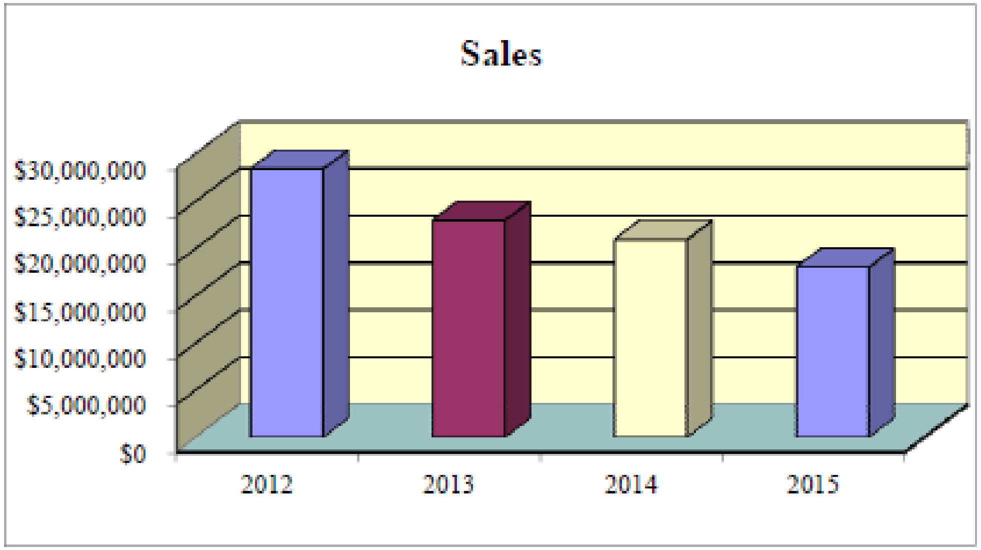

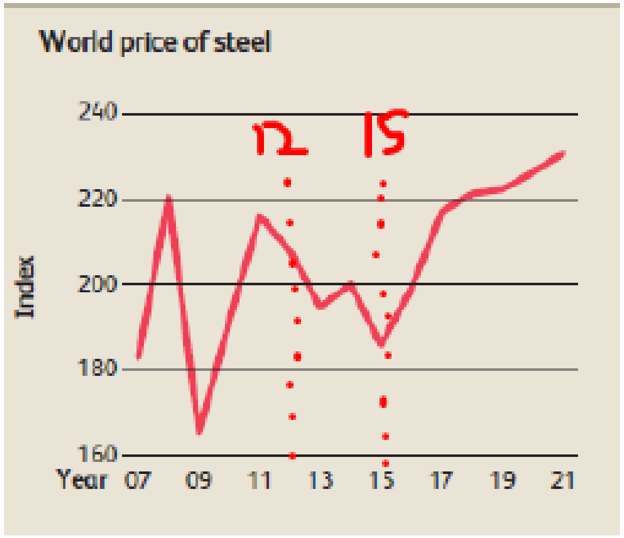

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